ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Shelley	Analyst:	Marion Mann DeJong	Bill Number:	AB 483
Related Bills:	See Legislative History	Telephone:	845-6979	Amended Date:	08/27/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Allow 100% Insurance Dividend Deduction/Ceridian v. FTB

SUMMARY

This bill would allow certain corporations a 100% deduction for dividends received from an insurance company subsidiary.

SUMMARY OF AMENDMENTS

The August 27, 2001, amendments deleted the provisions relating to the research credit and inserted the provision discussed above.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to resolve a constitutional issue by allowing certain taxpayers a deduction for dividends received from insurance company subsidiaries. The author feels that the alternative of denying the deduction would be tantamount to a retroactive tax increase for California taxpayers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, legislative declarations included in the bill specify that the amendments to existing law are a clarification of, and not a change from, existing law. Thus, the bill's amendments of existing law would apply to all open tax years. The bill's legislative declarations regarding clarifications of existing law do not clearly extend to the specific legislative declarations regarding the interpretation of the phrase "subject to tax imposed by Part 7." If this declaration were not considered a declaration of existing law, the interpretation would be applicable for taxable years beginning on or after January 1 of the taxable year in which the bill becomes effective.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are provided to resolve the "Technical Consideration" discussed below.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Gerald H. Goldberg	09/14/01
______ SA	______ O	______ NAR		
______ N	______ OUA	__X__ PENDING		

ANALYSIS

BACKGROUND

Generally, Section 24410 of the Bank and Corporation Tax Law (B&CTL) allows only corporations domiciled in California to claim a deduction for dividends received from an insurance company subsidiary subject to the gross premiums tax. The amount deductible is limited according to a formula based upon the subsidiary's gross receipts, payroll, and property within California.

On December 21, 2000, the California Court of Appeal ruled in *Ceridian Corp. v. Franchise Tax Board* (2000) 85 Cal App 4th 875 (modified 86 Cal App 4th 483), that the deduction for dividends received by corporations domiciled in California from insurance company subsidiaries is unconstitutional. The court also concluded that the provision was incapable of judicial reformation. Presently, FTB has not taken any action to implement the *Ceridian* decision.

FEDERAL/STATE LAW

Federal law allows a deduction for dividends received from a domestic corporation that is subject to income tax. The deduction is subject to specific reductions and limitations. Generally, the amount of the deduction is determined by the percentage of the taxpayer's ownership in the corporation as follows:

- 100% of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership).
- 80% of the deduction is allowed when received from a corporation that is greater than 20% but less than 80% owned.
- 70% of the deduction is allowed when received from a corporation less than 20% owned.

Federal law does not allow a deduction for dividends received from a foreign corporation unless the foreign corporation is wholly owned and has only effectively connected U.S. source income. If a domestic corporation owns 10% or more of a foreign corporation, it can elect to receive a tax credit for taxes paid to the foreign country.

Federal law does not contain business/nonbusiness income concepts because those concepts were developed by the states in response to constitutional limitations on state taxation. Therefore, there is no requirement under federal law to make expense allocations between business and nonbusiness income. Federal law does make expense allocations between foreign (non-U.S.) and domestic income and, by regulation, uses methods similar to those provided for in Regulation Section 25120(d) of title 18 of the California Code of Regulations.

Under California law, corporations deriving income from sources both within and outside California are required to measure their California tax liability by reference to their income derived from or attributable to sources within California. The amount of income derived from California is calculated by first characterizing income as business and nonbusiness.

To determine the portion of *business* income that is attributable to California, an apportionment formula is used. For most corporations, this formula is worldwide income multiplied by the average of the factors of property, payroll, and double-weighted sales. Each of these factors is the ratio of in-state activity to worldwide activity. Business income assigned to California is determined by multiplying total business income by the average California apportionment percentage.

Nonbusiness income is all income that is not *business* income and it is assigned by statute to a specific state. *Nonbusiness* income from intangible property is generally allocated to the taxpayer's commercial domicile. *Nonbusiness* income from tangible property is generally allocated to the physical location of the property.

California Regulation Section 25120(c)(4) applies the transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends also will be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose that furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials. (*Appeal of Standard Oil Company of California*, Cal. St. Bd. of Equal., March 2, 1983.)

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities.

Existing state law (B&CTL Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

Existing state law (B&CTL Section 24402) allows a deduction for a portion of any dividends received that are paid out of income that was subject to either the franchise tax, the alternative minimum tax, or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level.

Under the statute reviewed in *Ceridian* (B&CTL Section 24410), corporations commercially domiciled in California are permitted to deduct dividends received from an insurance company subsidiary operating in California that is subject to the gross premiums tax. The deduction is allowed if at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula based upon the subsidiary's gross receipts, payroll, and property within California.

The purpose of Section 24410 is to provide relief from double taxation similar to the relief provided to general corporations under the dividends received deduction of Section 24402.

Ceridian Case

The taxpayer in *Ceridian* challenged the limitation on the deduction for dividends received from insurance company subsidiaries set forth in B&CTL Section 24410. *Ceridian* was denied the deduction because the corporation was domiciled outside of California.

The California Court of Appeal ruled that the deduction for dividends received by holding companies from insurance company subsidiaries under B&CTL Section 24410 is unconstitutional for two reasons. First, it violated the commerce clause by allowing a deduction for insurance company dividends only to corporations domiciled in California. Second, it violated the commerce clause because the amount of the deduction is limited according to a formula based on the subsidiary's gross receipts, payroll, and property within California.

There are differing views on whether or how the deduction for dividends received from insurance company subsidiaries should be applied after *Ceridian*. Generally, if provisions of a statute are found to be unconstitutional, the remaining provisions of the statute can be preserved if the unconstitutional portion can be stricken without affecting the other parts. If the remaining provisions cannot be saved, the statute is void as unenforceable (*Kopp v. Fair Political Practices Comm*. (1995) 11 Cal. 4th 607, 641).

THIS BILL

This bill would allow taxpayers that own 80% or more of a subsidiary engaged in an insurance business a deduction for 100% of dividends received from that subsidiary.

The bill would make legislative declarations that the changes to B&CTL Section 24410 would be a clarification of, and not a change to, existing law. Further, the bill would declare that a provision of existing law should be interpreted so that subsidiaries are not required to be actually subject to the California gross premiums tax for its dividends to qualify for the deduction. Instead, the deduction would be allowed if the subsidiary would be subject to the gross premiums tax if it were doing business in California.

IMPLEMENTATION CONSIDERATIONS

Implementation of this bill would occur during the department's normal annual system update.

TECHNICAL CONSIDERATIONS

The legislative declaration of the phrase "subject to tax imposed by Part 7" to the effect that insurance companies "subject to" the gross premiums tax are not **actually** required to pay the gross premiums tax would require the department to interpret the phrase "subject to tax imposed by Part 7" differently from how the department has historically interpreted this phrase. Further, it would be interpreted differently from how the phrase is normally interpreted in California law. Generally, when the term "subject to" is contained in a statute, it is interpreted to require that the entity actually be subject to the specified taxing jurisdiction of the state. In addition, as indicated above, the bill's legislative declaration regarding clarification of existing law does not clearly extend to the interpretation of the phrase "subject to tax imposed by Part 7." The author might consider revising the bill to amend the statute to define insurance companies that can pay deductible dividends to mean any insurance company that would be subject to the gross premiums tax if it were doing business in California. The legislative declaration would be revised accordingly. Amendments that would make this change are provided.

LEGISLATIVE HISTORY

AB 1569 (Shelley, 2001/2002) would have allowed all corporations a deduction for dividends received from an insurance company subsidiary. AB 1569 was held in the Assembly Revenue and Taxation Committee.

SB 1229 (Committee on Revenue and Taxation, Stats. 1999, Ch. 987) and SB 2171 (Committee on Revenue and Taxation, 1999/2000) both contained provisions to amend B&CTL Section 24410 to allow all corporations a deduction for dividends received from an insurance company subsidiary. SB 1125 (Polanco, 1999/2000) would have allowed corporations to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income. SB 1229 was tied to SB 1125 so that if only SB 1229 were enacted, only technical changes would be made. SB 1125 was vetoed on October 10, 1999; thus, SB 1229 made only technical changes to B&CTL Section 24410. SB 2171 was held in the Senate Appropriations Committee.

OTHER STATES' INFORMATION

Information regarding how *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* treat dividends received from insurance company subsidiaries could not be found. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Review of *Florida, Illinois*, and *New York* laws found the following general information regarding deductible dividends.

Under *Florida* and *Illinois* laws, corporate income is determined by making adjustments to federal taxable income. Thus, the corporation is allowed the federal dividends received deduction. Some modifications are made to federal amounts if the amounts include Internal Revenue Code Section 78 dividends or dividends from foreign subsidiaries.

Under *New York* law, the federal deduction for dividends received is not allowed. However, 50% of all dividends from corporations other than from subsidiaries that were used in computing federal taxable income are allowed as a deduction.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

The revenue implications of this bill are dependent upon whether the disputed current baseline is a 100% deduction for dividends received from an insurance company subsidiary or no deduction is allowed. Under the latter position, revenue losses have been projected at $100 million for all open years and at $25 million annually for ongoing years based on very limited available information. Projected revenue losses for all open years would not be realized in the initial fiscal year. The actual cash flow impact would occur over a period consisting of several fiscal years as cases are closed.

However, if the current baseline reflects the former position of a 100% deduction, this bill would not impact revenues.

Revenue Discussion

The revenue effects would be determined by a number of factors: (1) the amount of dividends received by a recipient, (2) the amount of dividends identified as business income, (3) the average apportionment factor of each recipient, and (4) each recipient's tax liability in California.

Due to significant data limitations pertaining to this issue, the estimates above should be considered general orders of magnitude based on the collective judgment of departmental staff knowledgeable in this area.

ARGUMENTS/POLICY CONCERNS

The court in *Ceridian* concluded that Section 24410 was incapable of judicial reformation. As originally introduced, the legislation that added Section 24410 would have provided a 100% deduction for insurance company dividends. As enacted, the deduction was limited to dividends related to California source income. Consistent with these views, it is department staff's opinion that the unconstitutional provisions of Section 24410 cannot be severed, and, as a result of *Ceridian,* no deduction may be allowed absent legislative action. On the other hand, taxpayer representatives suggest that the offensive provisions of Section 24410 can be severed without legislative action.

The legislative declaration that the changes to B&CTL Section 24410 would be a clarification of, and not a change to, existing law is inconsistent with the court's conclusion in *Ceridian*. Further, the declaration that a provision of existing law should be interpreted so that subsidiaries are not required to be actually subject to the California gross premiums tax for its dividends to qualify for the deduction is inconsistent with how the department has historically interpreted this phrase and how the phrase is normally interpreted in California law.

Generally, the deduction for corporate dividends is limited to dividends paid from income previously taxed under the income or franchise tax (i.e., paid from California-source income). This bill would provide preferential treatment for insurance company dividends since 100% of the dividend would be deductible without regard to whether the dividend payor has California source income.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 483
As Amended August 27, 2001

AMENDMENT 1

On page 2, revise lines 6 through 10 as follows:

during the taxable year from ~~an~~ a qualified insurance company ~~subject to tax imposed by Part 7 (commencing with Section 12001) of this division at the time of the payment of the dividends and~~ where at least 80 percent of each class of its stock is owned by the corporation receiving the dividend.

(b) For purposes of this section, a qualified insurance company means a company that would be subject to the tax imposed by Part 7 (commencing with Section 12001) of this division if it were doing business in California at the time of the payment of the dividend.

AMENDMENT 2

On page 3, strikeout "(b)" and insert:

(c)

AMENDMENT 3

On page 4, revise line 21 as follows:

~~(b) The Legislature further finds and declares that the~~ (4) The reference